WJEC (Eduqas) Economics A-level

Macroeconomics

Topic 3: Policy Instruments

3.1 Fiscal policy

Notes

The government budget:

The government budget is comprised of tax revenues and government expenditure.

A government has a **budget surplus** when tax receipts exceed expenditure.

The government has a **balanced budget** when expenditure is equal to revenue.

A government has a **budget deficit** when expenditure exceeds tax receipts in a financial year.

It is important to distinguish between the government **debt** and the government **deficit.** The debt is the accumulation of the government deficit over time. It is the amount the government owes. The deficit (or surplus) is the difference between expenditure and revenue at any one point.

Current government expenditure is spending which recurs. This is on goods and services which are consumed and last for a short period of time. For example, it could be on drugs for the health service.

Capital government expenditure is spent on assets, which can be used multiple times. For example, it could be government expenditure on roads or building a school.

Direct and indirect taxes:

Direct taxes are imposed on income and are paid directly to the government from the tax payer. Examples include income tax, corporation tax, NICs and inheritance tax. Consumers and firms are responsible for paying the whole tax to the government.

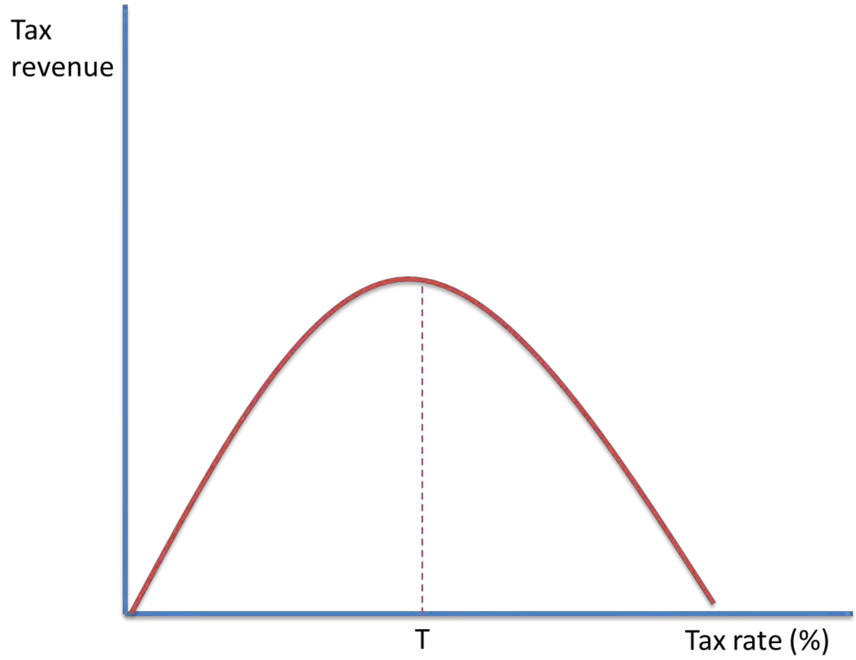
Indirect taxes are imposed on expenditure on goods and services, and they increase production costs for producers. This increases market price and demand contracts.

There are two types of indirect taxes:

- **Ad valorem** taxes are percentages, such as VAT, which adds 20% of the unit price. This is the main indirect tax in the UK.
- **Specific taxes** are a set tax per unit, such as the 58p per litre fuel duty on unleaded petrol.

The possible impact of changes in tax and spending on the economy:

The Laffer curve



The Laffer curve shows how much tax revenue the government receives at each level of tax. Up until the point 'T', as tax rates increase, government tax revenue increases. After point 'T', people do not think it is as worthwhile working, and the lack of incentive to work leads to falling tax revenue. 'T' is the optimum tax rate where the government can maximise their revenue. Laffer argued that tax rates are too high, so they provide a disincentive to work. To encourage people to work harder, Laffer argued, tax rates should be reduced.

How Keynesian economists believe that fiscal policy can and should be used to control the level of AD in the economy:

- Keynesian economists believe the government should intervene in the economy to overcome a lack of demand during recessions, which will also reduce the unemployment rate and help encourage economic growth.

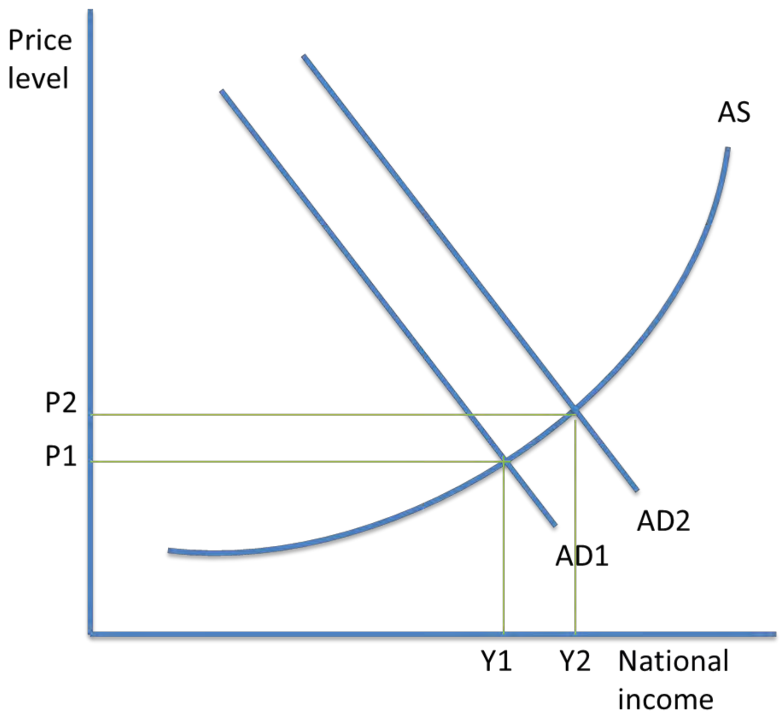
- Discretionary fiscal policy involves deliberate changes in government expenditure and taxes with the intention of influencing aggregate demand. Keynes believed that during recessions, governments should increase their spending, and finance this with more borrowing.

- Governments can change the amount of spending and taxation to stimulate the economy. The government could influence the size of the circular flow by changing the government budget, and spending and taxes can be targeted in areas which need stimulating. Fiscal policy aims to stimulate economic growth and stabilise the economy.

- In the UK, the government spends most of their budget on pensions and welfare benefits, followed by health and education. Income tax is the biggest source of tax revenue in the UK.

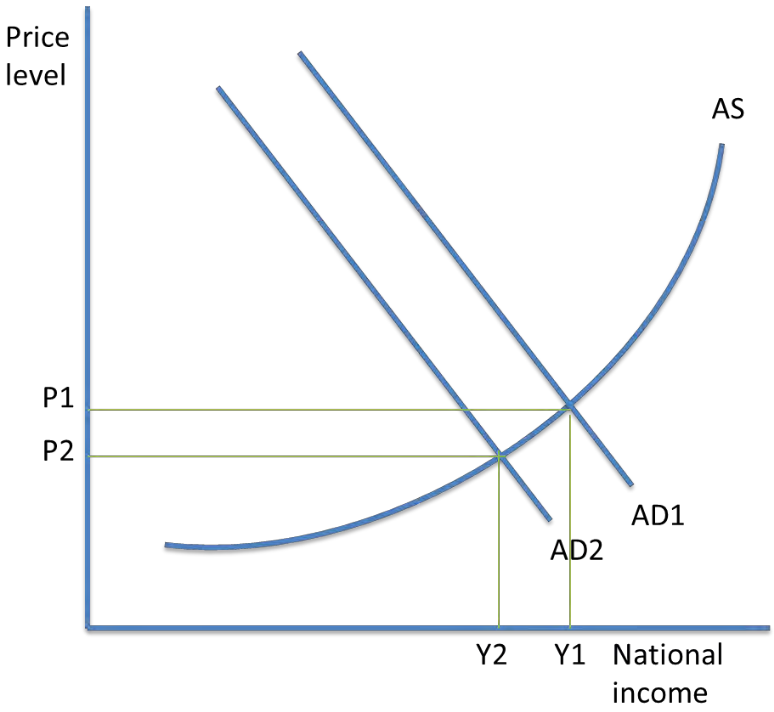
Expansionary fiscal policy

This aims to increase AD. Governments increase spending or reduce taxes to do this. It leads to a worsening of the government budget deficit, and it may mean governments have to borrow more to finance this.



Deflationary fiscal policy

This aims to decrease AD. Governments cut spending or raise taxes, which reduces consumer spending. It leads to an improvement of the government budget deficit.



How fiscal policy can be used to influence AS:

- The government could reduce income and corporation tax to encourage spending and investment. This influences incentives to invest and work. This is because, when workers keep more of their income, they are more likely to work. If income tax is very high, people might leave the labour market, since they might not consider it financially worthwhile to work.
- The government could subsidise training or spend more on education. This lowers costs for firms, since they will have to train fewer workers. Spending more on healthcare helps improve the quality of the labour force, and contributes towards higher productivity.

Limitations of fiscal policy:

- Governments might have imperfect information about the economy. It could lead to inefficient spending.
- There is a significant time lag involved with employing fiscal policy. It could take months or years to have an effect.
- If the government borrows from the private sector, there are fewer funds available for the private sector, which could lead to crowding out.
- The bigger the size of the multiplier, the bigger the effect on AD and the more effective the policy.
- If interest rates are high, fiscal policy might not be effective for increasing demand.
- If the government spends too much, there could be difficulties paying back the debt, which could make it difficult to borrow in the future.
- If government debts get too high, the cost of borrowing could increase, since by borrowing money, the government is increasing demand for credit in the economy. If confidence is lost in the government's ability to repay the debt, governments might have to raise interest rates to encourage investors to buy bonds, so that they can finance the debt. It could lead to higher taxes and austerity measures, especially if the debt becomes uncontrollable.